MARKET FAILURE AND PUBLIC SECTOR FAILURE: IS PRIVATIZATION A PANACEA?

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ABSTRACT

Although market failure is the primary economic justification for government intervention in the economy, the efficiency enhancement thought to stem from government involvement -- especially in the form of public ownership -- is not necessarily realized in practice. This paper argues that public sector inefficiency is attributed to a number of factors that share a common root: the absence of efficiency-promoting incentives. In contrast, the private sector incentive mechanism is more likely to encourage efficiency, suggesting that the privatization of state-owned enterprises may be the antidote to "public sector failure." Three privatization scenarios are then reviewed: (a) a private monopoly replaces a public monopoly, (b) a competitive market supplants a public monopoly, and (c) the public sector employs private enterprise to provide the service. While privatization can lead to increased efficiency in all 3 circumstances, the presence of monitoring costs should impose some caution on those who advocate privatization as a panacea.

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